

Subject: Management

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Paper: 12, Business Environment

Module: 25, Overview of Business Environment



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QUADRANT-I

Items	Description of Module
Subject Name	Business Environment
Paper Name	Business Environment
Module Title	Convertibility of Rupee
Module Id	Module no.-25
Pre- Requisites	Basic knowledge about the meaning of foreign exchange
Objectives	To study the meaning and methods of Convertibility
Keywords	Capital account, Current account, Convertability

QUADRANT-I

Module 25;Convertibility of Rupee
1. Learning Outcome
2. Introduction
3. Definitions of Convertibility
4. Meaning of Capital account
5. Meaning of Current account
6. Capital Account Convertibility of Rupee
7. Current Account Convertibility of Rupee
8. Tarapore Committee Recommendations
9. Summary

Learning Outcome: After completing this module the students will be able to:

- Understand the concept of Convertibility of Rupee
- Understand the Capital Account Convertibility of Rupee
- Understand the Current Account Convertibility of Rupee
- Know the Recommendations of Tarapore Committee

Convertibility of Rupee

Introduction

In India, some decades back, the exchange rate was controlled by RBI for conversion of Indian currency into foreign exchange. By virtue of this control all the foreign exchange earned was to be sold to authorized dealer and if we want to purchase foreign exchange we have to seek permission of central bank. The main purpose behind this was to utilize the foreign exchange earned by the residents as per the priorities fixed by the government. These controls were necessary at that time as India was underdeveloped country and its exports were limited to agricultural product and raw material and it used to import only consumable goods.

But now India is a fast developing country and one of the most preferred countries for investment by foreigners. India could not restrict its foreign trade as It needs to grow further. So government has allowed convertibility of rupee in phased manner on current account transactions. But full convertibility of currency for capital account transactions is still a distant dream.

Meaning

Convertibility of currency means when currency of a country can be freely converted into foreign exchange at market determined rate of exchange that is, exchange rate as determined by demand for and supply of a currency. For example, convertibility of rupee means that those who have foreign exchange (e.g. US dollars, Pound Sterlings etc.) can get them converted into rupees and vice-versa at the market determined rate of exchange.

Rupee is both convertible on capital account and current account.

What is a current account? It means all exports and imports of merchandise and invisible (like services etc).

What is a capital account? By capital account convertibility we mean that in respect of capital flows (that is, flows of portfolio capital, direct investment flows, flows of borrowed funds and dividends and interest payable on them) a currency is freely convertible into foreign exchange and vice-versa at market determined exchange rate.

Current Account Convertibility of rupee

Current account convertibility means when foreign exchange (e.g. Pound Sterling, U.S.Dollar etc) received for export of merchandise and services can be freely converted into Indian rupees and vice-versa in case of imports.

In the seventies and eighties many countries switched over to the free convertibility of their currencies into foreign exchange. By 1990, 70 countries of the world had introduced currency convertibility on current account and another 10 countries joined them in 1991.

As a part of new economic reforms initiated in 1991, India also joined the regime and made rupee partly convertible from March 1992 under the “Liberalized Exchange Rate Management scheme”. In this scheme, 60 per cent of all receipts on current account (i.e., merchandise exports and invisible receipts) could be converted freely into rupees at market determined exchange rate quoted by authorised dealers while 40 per cent of them were to be surrendered to Reserve Bank of India at the officially fixed exchange rate. These 40 per cent exchange receipts on current account was meant for meeting Government needs for foreign exchange and for financing imports of essential commodities. Thus, partial convertibility of rupee on current account meant a dual exchange rate system. Further, full convertibility of rupees at that stage was considered to be risky in view of large deficit in balance of payments on current account.

As even after partial convertibility of rupee foreign exchange value of rupee remained stable, this laid down a base for the full convertibility on current account. Hence, from March 1993, rupee was made convertible for all trade in merchandise. In March’ 1994, even indivisibles and remittances from abroad were allowed to be freely convertible into rupees at market determined exchange rate. But this does not mean that one can get any amount of foreign exchange for meeting one’s needs e.g. one cannot convert his savings in the country for investment in foreign exchange as could be done by citizens of developed countries like U.K. and USA. However, on capital account rupee remained non-convertible.

Advantages of Currency Convertibility

1. **Encouragement to exports:** Market rate remains generally higher than the officially determined exchange rate. This implies that from given exports, exporter can get more rupee against foreign exchange. This will help to increase exports
2. **Encourages import substitution:** Imports become expensive due to convertibility of rupee. So it discourages imports and boosts import substitution.
3. **Incentive to remittances from abroad:** Earlier, NRIs used to send money illegally to India such as Hawala money and gold etc. But due to removal of restrictions, NRIs can easily remit money to India. It will help to improve Balance of payment.
4. **Reduction in Malpractices:** The malpractices like under-invoicing of exports may not arise as rupee is fully convertible and they will get full value for their exports

5. A self – balancing mechanism:

Another important merit of currency convertibility lies in its self-balancing mechanism. When balance of payments is in deficit due to over-valued exchange rate, under currency convertibility, the currency of the country depreciates which gives boost to exports by lowering their prices on the one hand and discourages imports by raising their prices on the other.

In this way, deficit in balance of payments get automatically corrected without intervention by the Government or its Central bank. The opposite happens when balance of payments is in surplus due to the under-valued exchange rate.

Capital Account Convertibility of Rupee:

Capital Account Convertibility (CAC) is the freedom to convert local financial assets into foreign financial assets at market determined exchange rates. Referred to as ‘Capital Asset Liberation’ in foreign countries, it implies free exchangeability of currency at lower rates and an unrestricted mobility of capital. India, at present has partial capital account convertibility.

In India there are conflicting views regarding whether to move towards full convertibility of capital account or not. At present, there are limits on investment by foreign financial investors and also caps on FDI ceiling in most sectors, for example, 74% in banking and communication, 49% in insurance, 0% in retail, etc.

Advantages of capital account convertibility

(1) Unrestricted mobility of Capital:

Capital account convertibility allows free mobility of Capital into a country from the foreign investors. It allows converting the foreign exchange brought into as Capital to convert into rupees at market determined rates, which makes the investors encouraging. It allows the foreign investors to easily move in and move out from an economy. This enables the domestic companies to raise funds from abroad.

(2) Ability to invest in abroad easily:

Capital account convertibility allows the individuals of a nation to invest in abroad by easily converting their rupees into foreign exchange at the rates determined by the Market. This enables those potential domestic investors to acquire & own the assets in abroad.

(3) Improved access to global financial markets:

One can easily invest in the equity and debt markets of another economies alongside a reduction in the cost of capital

Disadvantages:

(1) Easier access to Hawala money:

As it allows converting any foreign receipt into Indian rupees at market determined rates there may be chance that domestic economy will be flooded with foreign exchange which in long run may damage the financial health of an economy.

(2) High volatility of markets:

During the times when the financial markets of an economy are doing good , a country may receive huge foreign investment. But during the adverse times the reverse scenario may happen. For example when the federal reserve Bank of America gave a sign that they are going increase the interest rates the foreign Institutional investors who invested their dollars in Indian stock market had withdrawn their investment from India which adversely impacted the rupee value.

Tarapore Committee on capital account convertibility

A committee on capital account convertibility was setup by the Reserve Bank of India (RBI) under the chairmanship of former RBI deputy governor S.S. Tarapore to "lay the road map" to capital account convertibility. In 1997, The Tarapore Committee had indicated the preconditions for Capital Account Convertibility. The three crucial preconditions were fiscal consolidation a mandated inflation target and strengthening of the financial system.

The five-member committee has recommended a three-year time frame for complete convertibility by 1999-2000. The highlights of the report including the preconditions to be achieved for the full float of money are as follows:-

- Gross fiscal deficit to GDP ratio has to come down from a budgeted 4.5 per cent in 1997-98 to 3.5% in 1999-2000.
- A consolidated sinking fund has to be set up to meet government's debt repayment needs; to be financed by increased in RBI's profit transfer to the govt. and disinvestment proceeds.

- Inflation rate should remain between an average 3-5 per cent for the 3-year period 1997-2000
- Gross NPAs of the public sector banking system needs to be brought down from the present 13.7% to 5% by 2000. At the same time, average effective CRR needs to be brought down from the current 9.3% to 3%.
- RBI should have a Monitoring Exchange Rate Band of plus minus 5% around a neutral Real Effective Exchange Rate RBI should be transparent about the changes in REER.
- External sector policies should be designed to increase current receipts to GDP ratio and bring down the debt servicing ratio from 25% to 20%.
- Four indicators should be used for evaluating adequacy of foreign exchange reserves to safeguard against any contingency. Plus, a minimum net foreign asset to currency ratio of 40 per cent should be prescribed by law in the RBI Act.

Apart from these essential pre-conditions, the Tarapore Committee also recommended that:

(a) RBI should have a monitoring exchange rate band of 5 per cent around Real Effective Exchange Rate (REER) and should intervene only when the RER is outside the band:

(b) The size of the current account deficit should be within manageable limits and the debt service ratio should be gradually reduced from the present 25 per cent to 20 per cent of the export earnings.

(c) To meet import and debt service payments, forex reserves should be adequate and range between \$ 22 billion and \$ 32 billion; and

(d) The Government should remove all restrictions on the movement of gold.

The Second Tarapore Committee on Capital Account Convertibility

Reserve Bank of India appointed the second Tarapore committee to set out the framework for fuller Capital Account Convertibility. The committee was established by RBI in consultation with the Government to revisit the subject of fuller capital account convertibility in the context of the progress in economic reforms, the stability of the external and financial sectors, accelerated growth and global integration. The report of this committee was made public by RBI on 1st September 2006 had drawn up a roadmap for 2011 as the target date for fuller capital convertibility of rupee

In this report, the committee suggested 3 phases of adopting the full convertibility of rupee in capital account.

First Phase in 2006-07

Second phase in 2007-09

Third Phase by 2011.

Following were some important recommendations of this committee:

- The ceiling for External Commercial Borrowings (ECB) should be raised for automatic approval.
- NRI should be allowed to invest in capital markets
- NRI deposits should be given tax benefits.
- Improvement in banking regulation.
- FII (Foreign Institutional Investors) should be prohibited from investing fresh money raised to participatory notes.
- Existing PN holders should be given an exit route to phase out completely the PN notes.

The fuller capital convertibility of rupee seemed to be desirable at the end of 2006 when the committee submitted its report. However, economic events, especially global financial crisis of 2007-09, brought about a sea change in the economic situation. It was evident that countries with full capital account convertibility were most affected. The Indian economy would have been greatly affected by the global financial crisis if we had implemented the recommendations of Tarapore Committee recommendation. We could not have coped with the extent of capital outflows that took place during 2008-09.

PRESENT STATUS OF CAPITAL ACCOUNT LIBERALISATION

Government of India (GOI) has revised rules pertaining to FEMA and capital account transactions during different periods of time. In context of large capital flows and the upshots of previous modifications during the last few years, GOI and RBI have recently done some additional amendments. The revisions related to capital account are listed below.

Account	Present Regulation
Authorised Dealers (AD)	<p>RBI has provided license to the entities for dealing in foreign exchange.</p> <p>They have 3 categories:</p> <p>a) Authorized Dealers Category-I (Public, Private and Foreign Banks).</p> <p>b) Authorized Dealers Category-II (Authorized on the city basis. They include cooperative banks, private forex dealers and travel agents etc.).</p> <p>c) Authorized Dealers Category-III (Nonbanking Finance Corporations)</p> <p>The authority vested in the hands of AD-I is largest (ranging from stock market transactions to NRI accounts, ECBs, ADRs etc.) while other categories of ADs have a limited role to play.</p>
FDI	<p>FDI is restricted in the following sectors:</p> <p>a) Multi brand retailing.</p> <p>b) Lottery (public, private, online), gambling, betting and casino.</p> <p>c) Chit funds and Nidhi Company.</p> <p>d) Trading in Transferable Development Rights in real estate business or construction of farm houses.</p> <p>e) Manufacturing of Cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes</p> <p>f) Atomic energy and Railway transport</p> <p>In rest other sectors such as agriculture, mining, manufacturing, broadcasting, print media, aviation, courier services, construction, telecom, banking, insurance etc; the limits of FDI range from 26% to 100%. All the foreign operators have to abide by the sectoral restrictions of the statutory regulators in addition to FDI rules.</p>
ADR/GDR by Indian Companies	<p>Indian companies can raise additional finances abroad through the issue companies of ADRs/ GDRs, in accordance with guidelines issued by the Government of India. Unlisted companies, which have not so far accessed the ADR/GDR route for raising funds in the global market, would require prior listing in the domestic market. Unlisted companies, which have already issued ADRs/GDRs in the international market, have to list in the domestic market on making profit or within three years of such issue of ADRs/GDRs, whichever is earlier.</p>

	<p>A Limited two way fungibility scheme is also operationalized through the custodians of securities and stock brokers under SEBI.</p>
<p>External Commercial Borrowings (ECBs)/ Foreign Currency Convertible Bonds (FCCBs)</p>	<p>The ECB limit under the automatic route is enhanced to USD 750 million (Circular No. 27 dated September 23, 2011). The maturity guidelines have also been revised (Circular No.64 January 05, 2012).</p> <p>(a) ECBs up to \$20 million in a financial year should have a minimum average maturity of three years.</p> <p>b) ECBs of more than \$20 million and up to \$750 million or equivalent should have a minimum average maturity of 5 years.</p> <p>c) Eligible borrowers under the automatic route can raise Foreign Currency Convertible Bonds (FCCBs) up to USD 750 million or equivalent per financial year for permissible end-uses.</p> <p>d) Corporates in services like hotel, hospital and software, can raise FCCBs up to USD 200 million or equivalent for permissible end-uses during a financial but the proceeds of the ECB should not be used for acquisition of land.</p> <p>e) ECB / FCCB availed of for the purpose of refinancing the existing outstanding FCCB should be viewed as part of the limit of USD 750 million available under the automatic route.</p>
<p>Government Securities</p>	<p>NRIs and SEBI registered FIIs are permitted to purchase Government Securities/ Treasury bills and Corporate debt. The details are as under:</p> <p>1. On repatriation basis a Non-resident Indian can purchase without limit,</p> <p>a) Dated Government securities (other than bearer securities) or treasury bills or units of domestic mutual funds.</p> <p>b) Bonds issued by a public sector undertaking (PSU) in India.</p> <p>c) Shares in Public Sector Enterprises being disinvested by GoI.</p> <p>2. On non-repatriation basis</p> <p>a) Dated Government securities (other than bearer securities) or treasury bills or units of domestic mutual funds.</p> <p>b) Units of Money Market Mutual Funds in India.</p> <p>c) National Plan/Savings Certificates.</p> <p>A SEBI registered FII may purchase, on repatriation basis, dated Government securities/ treasury bills, listed non-convertible debentures/ bonds issued by an Indian company and units of domestic mutual funds either directly from the issuer of such securities or through a registered stock broker on a recognized stock exchange in India.</p>

	<p>The FII investment in Government securities and Corporate debt is subject to the Investment limit. For the FIIs in Government securities currently is USD 10billion and limit in Corporate debt is USD 20 billion.</p>
Joint Venture/ Wholly owned subsidiary abroad	<p>An Indian Party is allowed to disinvest, without prior approval of RBI, subject to the satisfaction of following conditions:</p> <ul style="list-style-type: none"> a) The JV / WOS are listed in the overseas stock exchange. b) The Indian party is listed on a stock exchange in India and is having a net worth of INR 1000 million and investment in JV/WOS outside India is not exceeding USD 10 million. c) The Indian Party is an unlisted company and its investment in JV/WOS outside India does not exceed USD 10 million. d) The Indian party does not have any outstanding dues by way of dividend, technical know-how fees, royalty, consultancy, commission or other entitlements, and/or export proceeds from JV/WOS e) JV/WOS has been in operation for at least one full year and the Annual Performance Report together with the audited accounts for that year has been submitted to RBI f) The Indian party is not under investigation by Central Bureau of Investigation (CBI)/Directorate of Enforcement (DoE) /Securities and Exchange Board of India (SEBI) /Insurance Regulatory and Development Authority (IRDA) or any other regulatory authority in India <p>An Indian Party, which does not satisfy the conditions stated above for undertaking any disinvestment in its JV/WOS abroad, shall have to apply to the RBI for permission.</p>

Foreign investment (FII)	Institutional	<p>Non Resident Indians (NRI)/Persons of Indian Origin (PIO) are allowed to make direct investment in Indian companies under the automatic route. FII/ NRI/ PIO/HNIs are allowed to invest in the following:</p> <ul style="list-style-type: none"> a) Securities in the primary and secondary markets including shares, debentures, and warrants of companies, unlisted, listed, or to be listed on a recognized stock exchange in India b) Units of schemes floated by domestic mutual funds including the Unit Trust of India, whether listed or not listed on a recognized stock exchange c) Government securities d) Derivatives e) Commercial paper f) Security receipts g) Indian Depository Receipts <p>Investments in shares or convertible debentures of an Indian company engaged in the following type of activities are not permitted:</p> <ul style="list-style-type: none"> a) Chit fund or Nidhi company; b) Agricultural or plantation activities c) Real estate business; d) Construction of farm houses; or e) Dealing in Transfer of Development Rights (TDRs). <p>SEBI registered FIIs and its sub accounts cannot exceed 10% of the paid up capital of the Indian company. For High Net worth Individuals (HNIs), NRIs and PIOs this limit is 5%.</p> <p>Facilitators: Purchase is made through a stock exchange or through the designated branch of an authorized dealer.</p>
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Summary

So in India, there is free regime for current account transactions but still partial convertibility for capital account transactions. Many economics experts are of view that we need full capital account convertibility of currency. Recently RBI's governor Raguram Rajan, in an interview has suggested moving towards full capital account convertibility in short numbers of years. Mr. G Padmanabhan, Executive Director of the Reserve Bank of India (RBI), has suggested that India should move towards making the rupee more convertible for capital transactions by foreign investors. According to him keeping any restriction for too long could prove self defying. But he also said that How fast that movement should be would, however, depend on how fast the country could meet the pre-conditions such as fiscal consolidation, inflation control, low level of

NPAs (non-performing assets), low and sustainable current account deficit, strengthening of financial markets, prudential supervision of financial institutions etc. otherwise, it may prove very risky.